Mutual Funds Integrity and Fee Transparency Act of 2003
H.R. 2420
Section-by-Section

Section 1. Short title

Section 1 provides that H.R. 2420 may be cited as the "Mutual Funds Integrity and Fee Transparency Act of 2003" (the "Act").

Section 2. Improved Transparency of Mutual Fund Costs

Section 2(a) requires the Securities and Exchange Commission ("Commission"), within 270 days after enactment of the Act, to revise regulations under the Securities Act of 1933, the Securities Exchange Act of 1934 ("Exchange Act"), and/or the Investment Company Act of 1940 ("Investment Company Act") to require improved disclosure with respect to an open-end management investment company of the following:

(1) the estimated dollar amount of operating expenses that are borne by each shareholder;

(2) the structure of, or method used to determine, the compensation of portfolio managers;

(3) portfolio transactions costs, including commissions, set forth in a manner that facilitates comparison among investment companies;

(4) information concerning the company's policies and practices with respect to certain so-called "soft dollar arrangements," specifically, the payment of brokerage commissions to a broker who provides research services; and information concerning the company's policies and practices with respect to the payment of brokerage commissions to a broker who facilitates the sale and distribution of the company's shares; and

(5) information concerning so-called "revenue sharing," *i.e.*, payments by any person other than the company that are intended to facilitate the sale and distribution of the company's shares (*e.g.*, payments by the company's investment adviser or an affiliate of the adviser to a broker that sells fund shares); and

(6) information concerning so-called "breakpoint" discounts on front-end sales loads for which investors may be eligible, including the minimum purchase amounts required for such discounts.

With respect to "soft dollar arrangements," the research services covered are:

(1) furnishing advice, either directly or through publications or writings, as to the value of securities, the advisability of investing in, purchasing, or selling securities, and the availability of securities or purchasers or sellers of securities; or

(2) furnishing analyses and reports concerning issuers, industries, securities, economic factors and trends, portfolio strategy, and the performance of accounts.

These are the same research services included in the definition of "brokerage and research services" in sections 28(e)(3)(A) and (B) of the Exchange Act, for purposes of the safe harbor for certain "soft dollar arrangements" in section 28(e).

Section 2(a) requires that the improved disclosure be made in the quarterly statement or other periodic report to shareholders or other appropriate disclosure document. Section 2(b) provides that a disclosure is not considered to be made in an appropriate disclosure document if the disclosure is made exclusively in a prospectus or statement of additional information, or both. This section does permit the Commission to require that the required disclosure be made in a prospectus or SAI, so long as that disclosure is also provided in another appropriate disclosure document. Section 2 permits the Commission to consider whether a document provided by a broker or dealer, rather than the company, may be an appropriate disclosure document, *e.g.*, for disclosure of information concerning "revenue sharing" payments.

Section 3. Obligations Regarding Certain Distribution and Soft Dollar Arrangements

Section 3 amends section 15 of the Investment Company Act to require each investment adviser to a registered investment company to annually provide the company's board of directors with a report on:

(1) payments made by the adviser (or its affiliated person) to promote the sale of shares of the company ("revenue sharing");

(2) services provided to the company or paid for by brokers executing securities transactions for the company (or its affiliated person) ("directed brokerage"); and

(3) research services obtained by the adviser (or its affiliated person) from a broker as a result of securities transactions effected on behalf of the company ("soft dollar arrangements").

The section also establishes a fiduciary duty on the part of the board to supervise the adviser's direction of the company's brokerage transactions and to determine that the direction of fund brokerage is in the best interests of the shareholders of the investment company, and requires the board to determine that any revenue sharing payments are consistent with the provisions of the Act, *e.g.*, are not disguised payments from fund assets, and are in the best interest of the shareholders of the investment company.

Finally, section 3 gives the Commission rulemaking authority to implement the section.

Section 4. Mutual Fund Governance

Section 4(a) amends section 10(a) of the Investment Company Act to decrease the maximum allowable percentage of directors on fund boards who are interested persons from 60

percent to one third, and to prohibit an interested person from serving as the chairman of the board of the company.

Section 4(b) amends section 2(a)(19) of the Investment Company Act, which defines the term "interested person," to give the Commission authority to expand the definition to include natural persons who are unlikely to exercise an appropriate degree of independence as a result of:

(1) a material business relationship with the company, its investment adviser, or principal underwriter (or any of their affiliated persons), or

(2) a close familial relationship with any natural person who is an adviser or principal underwriter to the company (or any of their affiliated persons).

Section 4(b) also deletes from section 2(a)(19) references to broker-dealers and lenders as interested persons to permit the Commission to include persons with such material business relationships as interested persons in a rule adopted pursuant to its new authority.

Section 5. Audit Committee Requirements for Investment Companies

Section 5 extends to registered management companies and registered face-amount certificate companies certain audit committee requirements similar to those required by section 301 of the Sarbanes-Oxley Act of 2002 and codified in section 10A(m) of the Exchange Act for listed companies. Section 10A(m) required the Commission, by rule, to direct the national securities exchanges and national securities associations to prohibit the listing of any security of an issuer that is not in compliance with enumerated audit committee requirements.

Section 5(a)(1) amends sections 32(a)(1) and (2) of the Investment Company Act to make the audit committee of a registered management company or registered face-amount certificate company, rather than the independent members of the full board of directors, responsible for selection of the auditor. This conforms the Investment Company Act to the approach of section 301 of the Sarbanes-Oxley Act, which currently applies to investment companies that are listed for trading on an exchange, and section 202 of the Sarbanes-Oxley Act, which requires an issuer's audit committee to preapprove all auditing services and which applies to most investment companies because they are "issuers" under the Sarbanes-Oxley Act.

Section 5(a)(2) adds new section 32(d) to the Investment Company Act. Section 32(d)(1) of the Investment Company Act makes it unlawful for any registered management company or registered face-amount certificate company to file with the Commission any financial statement signed or certified by an independent public accountant unless the company is in compliance with certain audit committee requirements and Commission rules and regulations. The audit committee requirements, which are similar to those enumerated in section 301 of the Sarbanes-Oxley Act, are the following.

Section 32(d)(2) of the Investment Company Act requires the audit committee to be directly responsible for the appointment, compensation, and oversight of auditors, and requires auditors to report directly to the audit committee.

Section 32(d)(3) of the Investment Company Act requires each member of the audit committee to be an "independent" member of the board of directors. Section 32(d)(3)(B) of the Investment Company Act provides that, in order to be considered "independent," a member of an audit committee may not, other than in his or her capacity as a member of the audit committee, the board of directors, or any other board committee (i) accept any consulting, advisory, or other compensatory fee from the company or any affiliated person of the company; or (ii) be an "interested person" of the company, as that term is defined in section 2(a)(19) of the Investment Company Act. This definition of "independent" differs from the definition in section 301 of the Sarbanes-Oxley Act in that (i) the prohibition on the acceptance of fees has been broadened to affiliated persons of the company in recognition of the fact that investment companies typically are externally managed, with most services rendered to the company by its investment adviser or another third party; and (ii) the long-standing "interested person" standard of the Investment Company Act has been substituted for the "affiliated person" test of section 301, in recognition of the fact that the "interested person" standard is tailored to the particular circumstances of registered investment companies.

Section 32(d)(4) of the Investment Company Act requires the audit committee to establish procedures for (i) the receipt, retention, and treatment of complaints regarding accounting, internal controls, or auditing matters; and (ii) the confidential, anonymous submission by employees of the company and its affiliated persons of concerns regarding accounting or auditing matters. Section 32(d)(4)(B) of the Investment Company Act requires that the audit committee establish procedures for the confidential, anonymous submission of concerns regarding questionable accounting or auditing matters not only by employees of the company, but also by employees of the company's affiliated persons. This is broader than section 301 of the Sarbanes-Oxley Act, again to recognize the fact that investment companies typically are externally managed.

Section 32(d)(5) of the Investment Company Act requires the audit committee to have the authority to engage independent counsel and other advisers, as it determines necessary to carry out its duties.

Section 32(d)(6) of the Investment Company Act requires the company to provide appropriate funding, as determined by the audit committee, for payment of compensation to the auditors and any advisers employed by the audit committee.

Section 32(d)(7) of the Investment Company Act defines "audit committee" to mean (i) a committee of the board of directors that oversees the accounting and financial reporting processes of the company and audits of its financial statements; and (ii) if no such committee exists, the full board of directors.

Section 5(b) of the Act adds new section 10A(m)(7) to the Exchange Act, which exempts registered investment companies from the requirements of section 10A(m) (the codification of section 301 of the Sarbanes-Oxley Act) effective one year after enactment of the Act. Because all registered management companies and registered face-amount certificate companies are covered by new section 32(d) of the Investment Company Act, it is no longer necessary that

registered investment companies that are listed on an exchange be covered by section 10A(m) of the Exchange Act. This exemption does not, however, preclude a national securities exchange or national securities association from imposing audit committee requirements on listed investment companies in appropriate circumstances. In the event that the rules promulgated pursuant to this Section become effective prior to one year after enactment of the Act, the Commission may use its exemptive authority under the Exchange Act to exempt listed investment companies that are subject to the provisions of 10A(m) from those provisions so they will not be subject to two inconsistent regulatory requirements.

Section 5(c) requires the Commission to issue final regulations to carry out new section 32(d) of the Investment Company Act not later than 180 days after the date of enactment.

Section 6. Commission Study and Report Regulating Soft Dollar Arrangements

Section 6(a) directs the Commission to conduct a study of the use of soft dollars by investment advisers. The section requires the Commission, in preparing the report, to examine trends in soft dollar use during the preceding three years, the types of services provided, the extent to which use of soft dollars impairs the ability of investors to evaluate and compare expenses of investment companies, and the transparency of such arrangements. Finally, the study must address the Commission's view of whether section 28(e) of the Securities Exchange Act, which provides a "safe harbor" for soft dollar arrangements, should be repealed or modified.

Section 6(b) directs the Commission to submit a report on the soft dollar study to the Committee on Financial Services and the Senate Committee on Banking, Housing and Urban Affairs no later than 18 months after enactment of the Act.